Internal Revenue Service

memorandum

CC:TL-N-5906-88
Brl:JDMacEachen

date: JUN 22 1988

to: District Counsel, Louisville CC:LOU

from: Director, Tax Litigation Division CC:TL

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subject: In Re: [redacted]

This is in response to your request for technical advice of April 21, 1988.

ISSUE

Whether an escrow fund created upon confirmation of a plan pursuant to 11 U.S.C. §§ 1101-1146, and into which all proceeds generated in connection with the liquidation of the debtor will be placed, constitutes a separate taxable entity for federal tax purposes. 0641-0100

CONCLUSION

The creation of a separate entity for federal tax purposes is a question of substance. In the instant case, a liquidating or straight bankruptcy, the confirmation of the plan did not give rise to a separate taxable entity. Accordingly, interest earned on the escrow fund is taxable to the debtor.

FACTS

[redacted], founded in [redacted], was engaged in the wholesale distribution of hardware. As of the close of [redacted], [redacted] employed over [redacted] persons, and had sales of $[redacted].

In [redacted], [redacted], wholly owned by one [redacted], acquired the then publicly held shares of [redacted], and merged into [redacted], leaving [redacted] the sole shareholder of [redacted]. In [redacted] [redacted] refinanced its outstanding indebtedness, including that incurred by [redacted] in connection with the purchase of the [redacted] shares.

On [redacted], [redacted] filed a petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 1101-46. [redacted] remained in the hardware business until [redacted], at which time it terminated its business operations and began an orderly liquidation of its assets. Substantially all of the inventory and accounts receivable was sold to a single purchaser on [redacted].

On [redacted], the Bankruptcy Court had appointed a Creditor's Committee composed of [redacted]'s [redacted] largest unsecured creditors. After a review of [redacted]'s financial data, the Committee concluded that upon the liquidation of [redacted] and the satisfaction of the claims of the secured creditors, the unsecured creditors would receive nothing. Accordingly, the Committee began an investigation of [redacted]'s pre-petition operations and its acquisition by [redacted]. The Committee hoped to subordinate some of the secured claims, many of which had arisen as a result of the [redacted] refinancing, or recover additional funds on behalf of [redacted]. The Committee eventually determined that [redacted] and the Committee had potential causes of action under sections 544, 547 and 548 of the Bankruptcy Code, and under various state law theories. Specifically, the Committee determined that the merger, the [redacted] refinancing, and certain guarantees given to banks were potentially voidable.

On [redacted], [redacted], [redacted], the banks involved in the [redacted] refinancing, and the Committee entered into a settlement agreement whereby [redacted] agreed to pay $[redacted] into an escrow fund, the banks agreed to release certain of their secured claims, and both [redacted] and the banks were released from all claims which the creditors might have against them.

This settlement became the cornerstone of [redacted] (the Plan). The Plan, which was subsequently confirmed by the Court, contemplated the following. [redacted] took title, possession, and control of its assets and, with the advice and consent of the Committee, sold those assets. Sale proceeds were placed in an escrow fund for the benefit of the creditors. [redacted] continued in existence, its sole business being the orderly liquidation of its assets and any activities incidental thereto. [redacted] was directed to provide to the Committee and to the Court quarterly reports detailing all transactions and accounting for all proceeds. All existing claims against [redacted] were deemed satisfied, and released in full. Upon entry of a final order by the Court, the shares of capital stock of [redacted] will be cancelled and become null and void, and [redacted] will cease to exist.

Under the Plan, the Committee retained a veto power over [redacted]'s sale of its assets. In addition, the Committee is exclusively authorized to bring avoidance actions on behalf of [redacted] or to pursue any causes of action which might be part of the [redacted] estate. All proceeds of such actions are to be placed into the escrow fund for the benefit of the creditors. The Committee will remain in existence until all distributions have been made under the Plan. The Committee retained all rights, duties, and powers, including oversight over the payment of all claims aganist [redacted] and the supervision of the escrow.

Under the Plan, a local bank was chosen as the escrow agent, and directed to receive the proceeds of the liquidation of [redacted], any proceeds recovered by the Committee, and the $[redacted] to be paid over a five-year period by [redacted]. Subject to the retained jurisdiction of the Court, the escrow agent was directed to receive the funds, invest them in certain United States bonds of less than 180-day maturity, and pay out such funds only upon an order of the Court, entered upon the application of the Committee. The escrow agent will provide quarterly reports, detailing all distributions, to [redacted], the Committee and the Court. The escrow fund will remain in existence until the entry of a final order by the Court.

The Court retained jurisdiction for all purposes relating to and arising in connection with the Plan, including the determination and allowance of claims, the resolution of all actions arising under sections 541, 544-550, and 553 of the Bankruptcy Code, and the supervision of the Plan. The case will not be closed until [redacted] has fulfilled his $[redacted] commitment, and all distributions payable under the Plan have been made.

As noted above, all funds generated in the liquidation of [redacted], including any funds recovered by the Committee, and any funds payable by [redacted], are to be placed into an escrow fund for the benefit of the [redacted] creditors. The question presented is whether the escrow fund, created upon confirmation of the Plan, constitutes a taxable entity separate and distinct from [redacted].

RATIONALE

[redacted] filed its petition for relief under Chapter 11 of the Bankruptcy Code on [redacted]. Accordingly, it is subject to I.R.C. § 1399, which provides that in the case of corporate bankruptcies commencing more than 90 days after December 24, 1980, no separate taxable entity shall result from the commencement of a case under the Bankruptcy Code.

Further, Treas. Reg. § 1.641(b)-2(b) provides that the estate of an infant, incompetent, or other person under a disability, or, in general, of an individual or corporation in receivership or a corporation in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting, in that respect differing from the estate of a deceased person or a trust.

Section 6012(b)(3) of the Code states that in a case where a receiver, trustee in a case under Title 11 of the United States Code, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or sustantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns (i.e., on Form 1120 rather than on Form 1041).

Notwithstanding the foregoing, in Technical Advices dated August 21, 1987, and February 12, 1988, concerning the [redacted], this office concluded, on the facts before it that the entity which arose upon confirmation of a plan pursuant to Chapter 11 of the Bankruptcy Code was a separate taxable entity taxed as an estate pursuant to I.R.C. § 641. We enclose a copy of both advices for your convenience.

In the context of an individual bankruptcy, the Service has long taken the position that the intervention of the status of bankruptcy into the affairs of the individual gives rise to a taxable entity separate and apart from the individual bankrupt, an estate in bankruptcy. See O.D. 174, 1 C.B. 175 (1919); G.C.M. 24617, 1945 C.B. 235; Rev. Rul. 68-48, 1968-1 C.B. 301; Rev. Rul. 78-134, 1978-1 C.B. 197. This has now been incorporated in section 1399 of the Code. Presumeably, this is in recognition of the economic substance of the transaction, i.e., that the individual will continue to earn post-petition income not subject to the bankruptcy, while his assets, now in the hands of the bankruptcy trustee, will also continue to earn income.

In the context of the corporate bankruptcy, the Service has agreed that the intervention of the status of bankruptcy does not give rise to a taxable entity separate from the corporation. This position, too, is in recognition of the economic substance of the transaction, i.e., a corporation is generally indistinguishable from its assets. Once a corporation has entered bankruptcy, it remains indistinguishable from its assets, having no ability to earn income in the absence of the assets. When those assets are transferred to the bankruptcy trustee and subsequently liquidated, there is no separate entity that remains independent of the assets controlled by the trustee. See Richardson v. United States, 386 F. Supp. 424, at 427 (C.D. Cal. 1974), aff'd, 552 F.2d 291 (9th Cir. 1977).

However, this analysis does not apply in the context of a corporate bankruptcy where the corporation is partially severed from its assets such that both the corporation and its assets continue to earn income independently of one another. See Krause and Kapiloff, Bankrupt estate, Taxable Income and Trustee in Bankruptcy, 34 Fordham L. Rev. 401, 405-406 (1966). Thus, the Service has taken the position that in certain instances the partial severing of a corporation from its assets has given rise to a taxable entity separate and apart from the corporate bankrupt. See [redacted], G.C,M. 39368, I-270-84, at 9 (February 21, 1985).

In the subject case there can be no dispute as to whether [redacted]'s filing of a petition gave rise to a separate taxable entity. See section 1399 of the Code. The question presented is whether the creation of the escrow fund upon the confirmation of the Plan gave rise to a separate entity.

On the facts presented, it does not appear that Plan confirmation worked any substantial change on the relationship between [redacted] and its assets. Both [redacted] and its assets remained subject to the Committee, and to the Court. Unlike the situation considered in the prior Technical Advices, there was no partial severing of [redacted] from its assets, i.e., [redacted] did not retain a portion of its assets, while permanently placing the remainder at the disposal of its creditors. While [redacted] was apparently discharged (but see 11 U.S.C. § 1141(d)(3)), it remained subject to the jurisdiction of the Court, and will go out of existence upon completion of the Plan. Further, the status of the [redacted] assets did not change upon plan confirmation. The assets remained subject to the Committee and the Court, and as before, were held solely for the benefit of the creditors. Finally, it does not appear that the escrow agent had such autonomy as to deem the escrow a trust, and him a trustee. See, for example, Rev. Rul. 70-567, Holding # 1, 1970-2 C.B. 133 and Rev. Rul. 82-177, 1982-2 C.B. 365.

In effect, the [redacted] Plan is a liquidating or straight bankruptcy. The Service has never deemed straight corporate bankruptcies to give rise to separate taxable estates. Accordingly, we agree that the subject escrow fund does not constitute a separate taxable entity, but is taxable to [redacted].

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